Games People Play

October 2018

*"You have to learn the rules of the game,
and then you have to play better than anyone else." – Albert Einstein*

In July, Vanguard announced that it will offer commission-free trading for basically *all* ETFs (including those from major competitors) on it's online brokerage platform, without requiring revenue-sharing or shelf-space agreements. At first blush, this seems to be a simple price war on ETF trading fees, but it's actually bigger than that. Historically, most so-called no-transaction-fee ("NTF") platforms charged ETF providers for "shelf-space", costs which are typically passed onto the investor one way or another (providers like Vanguard and Dimensional are two companies that typically refuse to pay for shelf-space). Our guess is that not only do most people not even pay attention to this pay-to-play game, but they do not even understand that they (the investors) are indirectly paying the fees associated with this practice.

As a result of Vanguard's announcement, ETF providers may be compelled to create a "cleaner" version of ETFs with additional distribution costs stripped out. Correspondingly, custodians (brokerage firms, etc) may feel pressured to offer less conflicted ETF platforms where investors (or advisors) are charged a simple fee for the clearing and custodial services rather than hidden shelf-space agreements, making for a cheaper and more transparent situation.

Speaking of not paying attention, the stock market and its participants awoke to the fact that the bond market is shaking its shackles of low-rate containment. In less confusing words, rates rose dramatically recently, causing bond values to fall, which in turn spooked the stock market (forgive the Halloween pun). And if you think rates are not that high and did not move too dramatically, just consider that the 10-year US Treasury bond rose from 2.82% at the end of August to 3.23% on October 5th, which is a 15% increase in a very short period of time. And sure, everyone has been giving lip-service to the fact that rates will rise in the future, but when the future finally arrives sometimes it's a bit more startling than predicted.

During volatile times, it's good to remember that the short term does not equal the long term, and that different asset classes serve different purposes; it's the utility of an asset class that matters. So, though stocks may be volatile at times, they are meant for long term growth; bonds may move up or down in price, but the interest and principal can be a ballast against stocks and act as a mid-term asset base that allows you to hold stocks for the long term; and cash is meant to simply be there (i.e., liquid, safe, and boring) in the short-term so your income need is not dependent on the short term gyrations of the mid-term bonds or the long-term stocks.

As for what caused the rate increase, ironically enough it was all the good news. Gross domestic product grew at a very strong 4.2% annualized pace in the second quarter (reported in late July), manufacturing activity is robust, with the Institute for Supply Management's Purchasing Manager's Index reaching a 14-year high in August, and business confidence is strong (the NFIB Small Business Index recently reached its third-highest level in 45 years). Add to the mix a much better-than-expected ADP employment report and comments from Federal Reserve Chair Jerome Powell that the economic outlook is "remarkably positive", and the next thing you know rates shoot up and the stock market goes down.

Speaking of markets that have gone down, emerging market stocks have had a rough year so far. But remember, emerging market pullbacks are quite normal. According to LPL Research, the MSCI Emerging Markets Index pulled back at least 15% (intra-year peak to trough) 11 times in the last 15 years (in six of those years, the index finished the year higher). And though things could get worse before they get better, we believe the markets have already priced in a lot of bad news. We already know the dollar is strong and getting stronger, and that the China dispute could turn into a trade war, but we also know that a bad year might simply be following a good year (in 2017, the MSCI Emerging markets increased over 37%). Though we are not calling the all-clear signal, we remind ourselves that the markets are a discounting mechanism that look out six to twelve months rather than six to twelve days, and that a truly diversified investment portfolio needs to have global exposure. And, to paraphrase Buffett on the rules of the game, the time to be fearful is not when something has already performed badly, just as the time to be greedy is not when something has been doing so well for so long.

As always, please email or call with any questions regarding this newsletter or any other topic that needs to be addressed. As a quick reminder, however, Wynne and I will be on a belated 20th anniversary trip from October 14th until the 24th (Megan will be in the office and able to reach us if needed). In any event, have a great start to Fall, and thanks so much for your friendship, your trust, and your referrals!

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